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No. 10-148

Supreme Court, U.S.
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In The
Supreme Court of the United States

ESTATE OF JAMES F. SHEPPARD, By Its Co-Personal Representative, Michael E. McMorrow,

Petitioner,

v.

JESSICA SCHLEIS, JAMES SCHLEIS, MARY JO SCHLEIS and XYZ FINANCIAL INSTITUTIONS,

Respondents.

On Petition For A Writ Of Certiorari To The Supreme Court Of Wisconsin

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Wisconsin law authorizes payment-on-death (POD) accounts, that is, accounts that transfer to a beneficiary, outside of probate, upon the owner's death. Under the Wisconsin statute creating POD accounts, all ownership of the account remains with its owner for life and the owner may change the beneficiary or cancel the account at any time before death.

Under the Internal Revenue Code (Code), 26 U.S.C. §§ 2036 and 2207B, if a person transfers property, but retains its use or enjoyment for life, then the one who received the transfer – even if it is incomplete during the transferor's lifetime – must reimburse the transferor's estate for a proportionate share of estate taxes.

Thus, the question presented here is this:

Because the Code permits estate tax reimbursement only from those who have actually received a transfer of property during the transferor's life, does the Code apply to the creation of Wisconsin POD accounts, when Wisconsin law provides that until death, the owner retains complete ownership of the account?

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STATEMENT OF THE CASE

A. POD accounts are authorized by Wisconsin statute.

The POD accounts at issue here are authorized and governed by Wisconsin statute. In particular, Wis. Stat. § 705.03(2) describes the ownership attributes of POD accounts under Wisconsin law under a heading "Ownership during lifetime" and states that "Unless there is clear and convincing evidence of a different intent":

> A P.O.D. account *belongs to the original payee* during the original payee's lifetime and *not to the P.O.D. beneficiary or beneficiaries*. If 2 or more parties are named as original payees, during their lifetimes rights as between them are governed by sub. (1); and a surviving original payee *may revoke or amend the P.O.D. beneficiary designation at will*. (emphasis added).

A similar provision applies to accounts involving securities which are called Transfer on Death accounts or TODs. A parallel statutory provision, Wis. Stat. § 705.26, authorizes TOD accounts:

> The designation of a TOD beneficiary on a registration in the beneficiary form *does not affect ownership until the owner's death*. A registration of a security in beneficiary form may be *cancelled or changed at any time* by the sole owner of all then surviving owners, *without consent of the beneficiary*. (emphasis added).

Given the similarity between POD and TOD accounts, they will be referred to here collectively as simply "POD accounts."

B. James Sheppard establishes two POD accounts for his goddaughter, Jessica Schleis, and then dies without a will.

As the Wisconsin Supreme Court noted in its unanimous opinion, the facts are not in dispute here. App. at 5. (*Estate of Sheppard v. Schleis*, 324 Wis. 2d 41, 782 N.W.2d 85 (2010)).[1] James Sheppard established two POD accounts for his goddaughter, Jessica Schleis, at a Wisconsin brokerage firm and at a bank in Wisconsin. *Id.* at 5 and Estate's Petition for Certiorari at 7. In July 2007, Sheppard died without a will. App. at 5. The total value of the POD accounts at the time of his death was approximately $3.8 million. *Id.* At the time of Sheppard's death, Schleis was a minor and counsel for Sheppard's estate (Estate) informed Schleis' mother that her daughter must pay the federal and Wisconsin estate taxes for the POD accounts that she received. *Id.* at 6. Schleis' parents were later appointed guardians for their daughter along with a separate guardian *ad litem* who advised that she was not responsible for the estate taxes on the POD accounts. *Id.* at 7.

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[1] The record citations are to the Wisconsin Supreme Court's decision attached to the petitioner's appendix (App.).

C. The Wisconsin Supreme Court rules that Schleis is not responsible for federal estate taxes on the POD accounts.

The Estate brought suit against Schleis and her parents in Wisconsin state court seeking reimbursement for estate taxes of some $1,231,200, allegedly related to the POD accounts. Pet. at 7-8. The trial court granted Schleis' motion for summary judgment and found that she was not responsible for the estate taxes. App. at 2. The Estate appealed and the Wisconsin Supreme Court heard the case directly and bypassed the Wisconsin Court of Appeals. *Id.* at 1-2.

The appeal before the Wisconsin Supreme Court involved both federal and Wisconsin estate tax liability and the court ruled in favor of Schleis on both issues. *Id.* at 3. Here, the Estate's petition raises only the federal estate tax issue. In ruling for Schleis on this issue, the court began with the general rule that under the Internal Revenue Code (26 U.S.C. § 2002) the estate pays the taxes on all property, regardless of whether that property is probate property and thus in the possession or control of an executor, or is nonprobate property – such as POD accounts. *Id.* at 8-9. In other words, even if property was not in the executor's possession or control and passed to a recipient outside of probate, the general rule under the Code is that the estate is still responsible for all estate taxes related to the property. *Id.*

The court also noted that there are four exceptions to the general rule that the estate pays all of the

taxes, only one of which the Estate claims is relevant here. *Id.* at 9. In particular, § 2207B of the Code states that the estate may recover from a beneficiary a proportionate share of taxes related to "property included in the gross estate by reason of [26 U.S.C. § 2036] (relating to transfers with retained life estate)." Thus, since reimbursement under § 2207B is triggered only if the property was included in the gross estate under § 2036, the next step in the analysis is to examine § 2036.

Section 2036 begins with the heading, "Transfers with Retained Life Estate" and at § 2036(a), it states in pertinent part that "the gross estate include":

> the value of all property . . . of which the decedent has at any time made a transfer . . . by trust or otherwise, under which he retained for his life . . .
>
> (1) the possession or enjoyment of, or the right to the income from the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

As such, the court focused on whether Sheppard made a "transfer" of property within the meaning of § 2036 when he created the POD accounts. And it found that he did not. App. at 12-13. Specifically, the court held that under the Wisconsin statute, the depositor is the owner of the POD account and "controls the income, the principal, and the right to decide

who gets the property at the depositor's death." *Id.* at 13. Therefore, the court concluded that the depositor "*transfers nothing* during his or her life" and Sheppard "did not transfer any ownership rights or any rights to income during his life." *Id.* at 13-14.

The court also found that the recipient of a POD account "does not possess a remainder interest" and has only a "potential expectancy" and thus there is "no transfer to the recipient involved in the creation of a P.O.D. account during the decedent's lifetime as required by 26 U.S.C. § 2036." *Id.* at 14. Accordingly, the court ruled that the creation of the POD accounts were not "transfers" within the meaning of § 2036 and the Estate did not have a right to recover estate taxes against Schleis. *Id.* at 17.

Finally, it should also be noted that the issue here does not involve tax avoidance and whether estate taxes will be paid on the POD accounts. The POD accounts are unquestionably part of Sheppard's gross estate and any taxes must be paid to the United States government by the estate. *See* 26 U.S.C. §§ 2002, 2033. The dispute here is limited to the Estate's attempt to recover from Schleis a *pro rata* share of federal estate taxes related to the POD accounts.

SUMMARY OF ARGUMENT

POD accounts arise only from state law – in this case from Wisconsin statutes stating that the accounts belong to the owner who may cancel or change them at any time before death. And that state law plays a pivotal role when federal estate taxes are considered. This Court has long held that state law determines in the first instance the attributes of the property right at issue, while federal law determines how that right – as defined by state law – should be treated. Thus, the Wisconsin Supreme Court properly first determined that creating a POD account did not result in a transfer under Wisconsin law.

Here, the Estate argues that the Wisconsin court's decision is contrary to "preemptive federal law," but not one of the federal cases that it cites even mentions POD accounts. In fact, from the handful of federal court of appeals decisions spanning some 30 years that it does cite, it merely repeats generalized propositions that are a long way from showing any real conflict over the issue here – whether creating a POD account is a "transfer" within the meaning of § 2036 of the Code so as to require beneficiaries to pay a *pro rata* share of the taxes. And as such, the cases themselves are simply not on point.

Further, § 2036 is aimed at preventing tax avoidance when property has supposedly been transferred from an estate, while the owner still retains the use or enjoyment of it before death – and the cases relied on by the Estate turn on that question of tax

avoidance. But here, there is no issue of tax avoidance; the estate will pay the taxes. On the other hand, POD accounts are not aimed at tax avoidance, but are a means of avoiding probate. Thus, there is no conflict with any federal court of appeals decision, or any other court for that matter, as to whether the beneficiary of a POD account must pay directly or reimburse an estate for federal estate taxes.

The Estate also contends that the Wisconsin court's decision conflicts with this Court's decision in *United States v. O'Malley*, 383 U.S. 627 (1966). But *O'Malley* also has nothing to do with POD accounts. The Estate cites it for the general proposition that § 2036 applies to "incomplete" transfers. But that has never been disputed. What the Estate overlooks is that the Wisconsin court found that creating a POD account did not result in *any* transfer – let alone an incomplete one – since the owner retains complete control over the account until death. As such, there is neither a conflict with any decision of this Court nor any conflict among the circuits, and thus, the Estate's petition should be denied.

ARGUMENT

A. For federal estate taxes, state law determines the contours of the property interest, while federal law determines how the interest should be treated.

In its petition, the Estate contends that the Wisconsin Supreme Court erred because it used "traditional Wisconsin property law" when analyzing whether the creation of the POD accounts were transfers within the meaning of § 2036. Pet. at 10, 17. Yet such a claim ignores a fundamental starting point in the analysis: PODs are, by their very nature, created by state law and federal law has never had a hand in regulating them. As the court stated in *Bruckner v. Prairie Fed. Savings & Loan Assoc.*, 81 Wis. 2d 215, 220, 260 N.W.2d 256, 258 (1977), "federal law is silent on the subject of POD accounts." And though POD accounts are not unique to Wisconsin law, they remain the product of individual state statutes. *See, e.g., In re Hall*, 394 B.R. 582, 595 (Bankr. D. Kan. 2008) (POD accounts authorized by state statute); *Spiess v. Schumm*, 442 N.W.2d 179, 180 (Minn. App. 1989) (POD accounts governed by Minnesota statute).

Moreover, the Estate's argument that the Wisconsin Supreme Court erred by applying "traditional property law" is directly contrary to a longstanding line of federal precedent, including that of this Court; namely, that when interpreting the Internal Revenue Code, state law defines the characteristics of the property interest, while federal law determines how

that property interest, once defined, will be treated. The fundamental role that state law plays in defining property interests was recognized long ago by this Court in *Morgan v. Comm'r*, 309 U.S. 78, 90 (1940): "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." The Eighth Circuit quoted this same statement from *Morgan* in *Senda v. Comm'r*, 433 F.3d 1044, 1049 (8th Cir. 2006) and pointed out: "This approach balances the legitimate and traditional interest of the State in creating and defining property interests, and the necessity for uniform administration of the Internal Revenue Code," *citing Aquilino v. United States*, 363 U.S. 509, 513 (1960).

Thus, federal courts must first look to state law to determine the characteristics of the property interest at issue. As the Seventh Circuit emphasized in *Estate of Bowgren v. Comm'r*, 105 F.3d 1156, 1161 (7th Cir. 1997): "Where federal tax liability turns upon the character of the property interest, federal courts are constrained to follow state law determinations of the interest in or right to such property," *quoting Estate of Lidbury v. Comm'r*, 800 F.2d 649, 652 n.3 (7th Cir. 1986). *See also Pyle by Straub v. United States*, 766 F.2d 1141, 1143 (7th Cir. 1985) (Illinois law determines whether gift was made for federal gift tax statute, *citing Morgan*). As such, when the Wisconsin Supreme Court determined the characteristics of PODs accounts created under the Wisconsin statute, it was doing precisely what federal

precedent has long held should be done for property interests to be treated under the Internal Revenue Code.

B. The Wisconsin Supreme Court's decision did not create a conflict with any federal circuit or any other court.

The Estate also contends that the Wisconsin Supreme Court's decision is "in conflict with preemptive federal estate tax law." Pet. at 3, 26. But this supposed conflict consists of a handful of decisions from the United States Courts of Appeal from 1966 to 1997 – not one of which ever mentions POD accounts and do not show any conflict with the Wisconsin court here.

The Estate first claims that the court's decision is at odds with *Sulovich v. Comm'r*, 587 F.2d 845 (6th Cir. 1978). Pet. at 3-4. But *Sulovich* dealt with joint trust accounts and whether establishing such trusts were gifts that placed them outside the settlor's estate. *Id.* at 846-47. The court held that though the settlor had sent the beneficiaries the passbooks for the accounts, the actual signature cards stated that the settlor retained the exclusive right to use the funds, and as a result, no gift had been completed. *Id.* at 849-50. Thus, because the transfer was incomplete, the accounts were, under § 2036, included in the settlor's gross estate. *Id.* But *Sulovich* does not present any sort of conflict with the court here. *Sulovich* did not deal with POD accounts and was limited to

whether creating the joint accounts transferred the *entire* interest to the beneficiaries, which the court held it did not. Yet in *Sulovich*, the transferor actually transferred *some* interest – though incompletely. On the other hand, here the issue is not whether Sheppard retained rights in the accounts – he obviously did – but whether he transferred *any* interest. And the Wisconsin court held that based on the Wisconsin statute, he did not.

The Estate tries to expand the reach of *Sulovich* by linking it to *dicta* in *McCarty v. State Bank of Fredonia*, 14 Kan. App. 2d 552, 558, 795 P.2d 940, 944-45 (1990) that "Totten Trusts" are similar to POD accounts and *Sulovich* dealt with a Totten Trust. Pet. at 4-5, 20-21. But under no reading of *McCarty* would it create a conflict as to federal tax law. First, *dicta* from an intermediate state appellate court does not create a conflict among the federal circuits. Second, *McCarty* is not a tax case at all, but deals with spousal rights under state law, where the court considered whether an individual retirement account was the same as a POD (it wasn't); it nowhere mentions § 2036. Third, *McCarty* does not conflict with the Wisconsin court here; it dealt with the Kansas POD statute and stated that the "disposition of the funds," not the *creation* of the funds, was "identical." 14 Kan. App. 2d at 558, 795 P.2d at 944-45.

The Estate also claims the Wisconsin court's decision conflicts with *Doerr v. United States*, 819 F.2d 162 (7th Cir. 1987) – supposedly because *Doerr* makes a reference to a "broad" interpretation of a

"transfer." Pet. at 10. But that mention of a broad construction refers to the gift tax statute and dealt with whether giving up the right to seek contribution for Wisconsin gift taxes was itself a gift under federal law. *Id.* at 164-65. The court held that is was. But the case dealt neither with POD accounts, nor § 2036. Moreover, as the court here stated when finding that *Doerr* did not apply: "Here, it cannot be said that when the decedent created the P.O.D. accounts he released any valuable right." App. at 14, n.10.

In addition, the Estate claims that language in *United States v. Heasty*, 370 F.2d 525, 528 (10th Cir. 1966) to the effect that "traditional concepts of property law" were rejected in favor of "a federal estate tax concept" also means there is a conflict. Pet. at 15. Yet the facts and holding of *Heasty* do nothing to advance this claim. There, a husband transferred a half-interest in property to his wife and they, in turn, transferred the property to their children, but retained a life estate for themselves. 370 F.2d at 526-27. The issue was whether under § 2036 the entire property should be included in the husband's estate or just his half-interest. *Id.* The district court applied state law to find that the husband had made a transfer of the half-interest and therefore only his remaining half-interest could be included in his estate under § 2036. *Id.* at 527. The court of appeals affirmed and concluded that the husband had conveyed a half-interest completely to his wife, and therefore, it was *not* part of his estate under § 2036. *Id.* at 528. In fact, contrary to the Estate's contention, the court expressly relied

on state law: "The 'interest' contemplated by section 2036 must, in a case like the one at bar, be determined according to state law." *Id.* at 529. Thus, if anything, *Heasty* only undermines the Estate's argument.

Finally, the Estate cites two decisions from the Seventh Circuit. Pet. at 25. Neither deals with POD accounts and neither has any bearing on the issue that the Wisconsin Supreme Court decided. In *Estate of Prudowsky v. Comm'r*, 465 F.2d 62 (7th Cir. 1972) (*per curiam*) the court merely concluded that a decedent's supposed "subjective and unilateral intentions" that he not retain control over assets did not override the express terms of the agreement stating that he did have such control and so, under § 2036, the assets were part of his estate. *Id.* at 62. The decision in *Estate of Bowgren v. Comm'r*, 105 F.3d 1156, 1164 (7th Cir. 1997) deals with the unique features of Illinois land trusts and holds that the decedent's power to direct the trustee of the land trust was sufficient under § 2036 to place the property in her gross estate. Again, this has nothing to do with POD accounts, and as noted above, *Bowgren*, expressly relied on state law to determine the particular ownership attributes for the property interest. *Id.* at 1161.

In sum, none of the court of appeals decisions cited by the Estate deal with POD accounts and none present any conflict with the Wisconsin Supreme Court. In fact, courts that have considered the actual question of whether creating a POD account is a transfer under § 2036 align squarely with what the

Wisconsin court decided in this case. In *Farris v. Cook*, 2007 WL 2482253 (Mo. App. Sept. 25, 2007), the court decided the same question decided by the court here and reached the same conclusion by holding that § 2036 does not apply to POD accounts. Interpreting the Kansas POD statute, the court stated: "The court does not find that a POD account is a transfer with a retained life estate. A POD account creates no interest in a named payable-on-death designee when the account is established. The person who establishes a POD account owns that account and has sole control over the account." *Id.* at *5. *See also In re Holter*, 401 B.R. 372, 374-75 (Bankr. W.D. Wis. 2009) (court follows *Farris* to hold that POD account is not property of the beneficiary when deciding if accounts were part of his bankruptcy estate).

C. The Wisconsin Supreme Court's decision is not contrary to decisions of this Court.

The Estate also argues that the Wisconsin court's decision is contrary to this Court's decision in *United States v. O'Malley*, 383 U.S. 627 (1966). Pet. at 3, 20, 24. The Estate never mentioned the *O'Malley* decision until its motion to reconsider below and for that reason it is not discussed in the Wisconsin court's opinion. In any event, the court's decision is not contrary to *O'Malley*.

In *O'Malley*, this Court considered whether income from irrevocable trusts should be deemed part of the decedent's gross estate under the predecessor

to § 2036 and concluded that it should. There, when the decedent created the trusts, he had "divested himself of all power and control over accumulated income" and thus made a "transfer" within the meaning of the statute. 383 U.S. at 632. But, at the same time, the Court found that this transfer was still incomplete and thus part of the estate, because the decedent still retained the power to designate whether the income would be paid to the beneficiaries or accumulated with the trust principal. *Id.* at 633.

Yet *O'Malley* has nothing to do with POD accounts and the Estate cites it for the general proposition that § 2036 applies to incomplete *inter vivos* transfers. Pet. at 14, 20. But that basic proposition has never been disputed here. In fact, this is the fundamental policy underlying § 2036 – to capture transfers that are in effect attempts to remove property from an estate, when the transferor still retains the use or enjoyment of the property. *See United States v. Grace*, 395 U.S. 316, 320 (1969) (purpose behind predecessor to § 2036 is to include transfers that are "essentially testamentary – *i.e.* transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime."). In essence, § 2036 addresses tax avoidance schemes that elevate form over substance. *See Estate of Stewart v. Comm'r*, ___ F.3d ___, 2010 WL 3078783, *3 (2d Cir. Aug. 9, 2010) ("The purpose of § 2036 is to prevent individuals from using a gift transfer of property with reservation of a life estate – or similar

device – in order to avoid having to pay the estate tax.").

But as noted above, tax avoidance is not an issue here; the value of the POD accounts are part of Sheppard's gross estate. *See* 26 U.S.C. § 2033 (gross estate includes value of all property at time of death). The executor must pay those taxes. *See* 26 U.S.C. § 2002. And there is also no dispute that § 2036 includes "incomplete" transfers where the decedent transferred part of an interest, but still retained part of it. Yet what the Estate overlooks here is that the Wisconsin Supreme Court has found, as a matter of Wisconsin law, that creating POD accounts is not a transfer of *any* kind – "incomplete" or otherwise. Thus, the case law that the Estate cites involving whether or not the decedent retained *some* interest in an incomplete transfer (*see, e.g., Grace*, 395 U.S. at 322-23) are beside the point. This case deals not with whether a decedent retained any interest in the POD accounts – he plainly did – but the unequivocal ruling of a state court that a property interest created under state law does not result in a transfer of any kind.

The Estate also cites this Court's decision in *Grace* to claim that § 2036 encompasses *any* transfer "taking effect at death or made at the contemplation of death." Pet. at 23. Yet the *Grace* decision nowhere makes such a sweeping statement. Rather, as noted above, *Grace* stated that the "general purpose" of § 2036's predecessor was to include in a gross estate what were "essentially testamentary" transfers that still left the transferor with significant control during

his lifetime. 395 U.S. at 320. For that reason, it held that "reciprocal trusts" created by a husband and wife that left them in "approximately the same economic position" did not result in removing the trust from the decedent's estate for tax purposes. *Id.* at 324-25.

Here, however, there is no issue of tax avoidance and § 2036 is relevant to this case not because of any tax avoidance issues, but only because it is incorporated in § 2207B, the tax apportionment statute. And § 2207B is, after all, an *exception* to the general rule that the executor of an estate pays all the taxes. 26 U.S.C. § 2002. If every person who received a bequest at death were responsible for a share of the estate taxes, then the § 2207B exception would swallow the general rule whole. Thus, the Estate's argument is not only devoid of any case law support, it runs contrary to the language of §§ 2036 and 2207B and the fundamental structure of the federal estate law. As the court stated in *Arzt v. Savarese*, 36 F. Supp.2d 653, 655-56 (D. Del. 1999). "A transfer on or after the decedent's death falls outside the scope of Section 2036, because one cannot retain a life interest after one's death," and that if "Congress wanted section 2207B to be effective on the death of a decedent, it could have so done as it did in [each of the other exception sections]." Thus, the Estate has not shown any conflict between the Wisconsin Supreme Court's decision and any decision of this Court.

CONCLUSION

At most, the Estate has presented a policy argument about whether POD accounts should receive special treatment under the Internal Revenue Code's tax apportionment sections – which currently say nothing about such accounts. Thus, if anything, this would be an issue for Congress to decide. But the Estate comes nowhere near showing that there is any conflict with the federal circuits or with any decision of this Court. Therefore, the petition should be denied.

Respectfully submitted,

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